MICHIGAN

OFFICE OF THE AUDITOR GENERAL

AUDIT REPORT

FINANCIAL AUDIT
OF THE

MICHIGAN TOBACCO SETTLEMENT FINANCE AUTHORITY
(A Blended Component Unit of the State of Michigan)

October 1, 2006 through September 30, 2007

THOMAS H. MCTAVISH, C.P.A.
AUDITOR GENERAL

271-0285-08

The auditor general shall conduct post audits of financial transactions and accounts of the state and of all branches, departments, offices, boards, commissions, agencies, authorities and institutions of the state established by this constitution or by law, and performance post audits thereof.

– Article IV, Section 53 of the Michigan Constitution

Audit report information can be accessed at:
http://audgen.michigan.gov

Michigan
Office of the Auditor General
REPORT SUMMARY

Financial Audit

Michigan Tobacco Settlement Finance Authority
(A Blended Component Unit of the State of Michigan)
Fiscal Year Ended September 30, 2007

Report Number:
271-0285-08

Released:
February 2008

A financial audit determines if the financial statements are fairly presented; considers internal control over financial reporting; and determines compliance with requirements material to the financial statements. This financial audit of the Michigan Tobacco Settlement Finance Authority was conducted as part of the constitutional responsibility of the Office of the Auditor General.

Financial Statements:

Auditor's Report Issued

We issued an unqualified opinion on the Michigan Tobacco Settlement Finance Authority's financial statements.

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Internal Control Over Financial Reporting

We did not report any findings related to internal control over financial reporting.

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Noncompliance and Other Matters Material to the Financial Statements

We did not identify any instances of noncompliance or other matters applicable to the financial statements that are required to be reported under *Government Auditing Standards*.

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Background:

The Michigan Tobacco Settlement Finance Authority was authorized by the provisions of Act 226, P.A. 2005. The Authority is administered by a board that consists of the State Treasurer, the director of the Department of Labor and Economic Growth, and 5 members who are appointed by the Governor with consent from the Legislature.

The Authority's purpose is to issue bonds secured by a pledge of a percentage of the State of Michigan's tobacco settlement proceeds. As of September 30, 2007, the Authority has made two issuances totaling $1,013.5 million of taxable and tax-exempt tobacco settlement asset-backed bonds. The bonds are special revenue obligations of the Authority secured solely by and payable solely from tobacco settlement revenue pledged under the bond indenture. The bonds are not an obligation of the State of Michigan and are not backed by the credit, revenues, or taxing power of the State.

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A copy of the full report can be
obtained by calling 517.334.8050
or by visiting our Web site at:
http://audgen.michigan.gov

Michigan Office of the Auditor General
201 N. Washington Square
Lansing, Michigan 48913

Thomas H. McTavish, C.P.A.
Auditor General

Scott M. Strong, C.P.A., C.I.A.
Deputy Auditor General

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THOMAS H. MCTAVISH, C.P.A.
AUDITOR GENERAL

February 28, 2008

Mr. Robert J. Kleine, Chair
Michigan Tobacco Settlement Finance Authority Board
Richard H. Austin Building
Lansing, Michigan

Dear Mr. Kleine:

This is our report on the financial audit of the Michigan Tobacco Settlement Finance Authority, a blended component unit of the State of Michigan, for the period October 1, 2006 through September 30, 2007.

This report contains our report summary, our independent auditor's report on the financial statements, the Authority management's discussion and analysis, and the Authority financial statements. This report also contains our independent auditor's report on internal control over financial reporting and on compliance and other matters and a glossary of acronyms and terms.

We appreciate the courtesy and cooperation extended to us during this audit.

Sincerely,

Thomas H. McTavish, C.P.A.
Auditor General

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INDEPENDENT AUDITOR'S REPORT

STATE OF MICHIGAN
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THOMAS H. MCTAVISH, C.P.A.
AUDITOR GENERAL

Independent Auditor's Report on
the Financial Statements

Mr. Robert J. Kleine, Chair
Michigan Tobacco Settlement Finance Authority Board
Richard H. Austin Building
Lansing, Michigan

Dear Mr. Kleine:

We have audited the accompanying financial statements of the Michigan Tobacco Settlement Finance Authority, a blended component unit of the State of Michigan, as of and for the fiscal year ended September 30, 2007*,* as identified in the table of contents. These financial statements are the responsibility of the Michigan Tobacco Settlement Finance Authority's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As described in Note 1, the financial statements present only the Michigan Tobacco Settlement Finance Authority and do not purport to, and do not, present fairly the financial position of the State of Michigan or its component units as of September 30, 2007 and the changes in financial position thereof for the fiscal year then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to in the first paragraph present fairly, in all material respects, the financial position of the Michigan Tobacco Settlement Finance Authority as of September 30, 2007 and the changes in financial position for the fiscal year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated December 21, 2007 on our consideration of the Michigan Tobacco Settlement Finance Authority's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of the internal control over financial reporting and compliance and the results of that testing and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The management's discussion and analysis on pages 11 through 14 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Sincerely,

Thomas H. McTavish

Thomas H. McTavish, C.P.A.
Auditor General
December 21, 2007

MANAGEMENT'S DISCUSSION AND ANALYSIS

The Michigan Tobacco Settlement Finance Authority provides this Management's Discussion and Analysis of the Authority's financial statements. The following narrative and overview of the financial activities of the Authority is for the fiscal year ended September 30, 2007 and for the period November 21, 2005 through September 30, 2006. The Authority encourages readers to consider this information in conjunction with the Authority's financial statements, which follow this section.

Using the Financial Report

These financial statements are prepared in accordance with Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments.*

The reporting standards require entity-wide financial statements and fund level financial statements and a reconciliation between the two types of statements. The Authority's basic financial statements include a statement of net assets; a governmental fund balance sheet; a statement of activities; and a governmental fund statement of revenues, expenditures, and changes in fund balance.

Financial Analysis of the Authority

The principal activity of the Authority for fiscal year 2006-07 was the sale of an additional $523.0 million of bonds for a total of $1,013.5 million in bond proceeds since the creation of the Authority. The proceeds were used to finance a $415.0 million transfer to the State School Aid Fund and the General Fund. In return for the distribution to the State, the Authority will receive a total of 24.11% of the payments received by the State under the master settlement agreement (MSA) signed in 1998 (10.77% related to the 2007 bond issuance and 13.34% related to the 2006 bond issuance). These payments will be used to repay the 2007 and 2006 issued bonds and interest.

The Authority's entity-wide financial activity for the period resulted in negative net assets of $835.5 million and $411.3 million at September 30, 2007 and September 30, 2006, respectively. The negative net assets for the period resulted from the Authority recording liabilities and transferring the bond proceeds to the 21st Century Jobs Trust Fund, State School Aid Fund, and General Fund for the entire amount of outstanding bonds, in accordance with accounting principles generally accepted in the United States of America. The bonds are payable only from proceeds from the Authority's share of future MSA receipts; however, accounting principles preclude the Authority from recording anticipated receipt of those proceeds because the underlying economic event has not yet occurred. By purchasing the bonds, the buyers of the Authority's bonds demonstrated their belief that those proceeds will be realized by the Authority and will be used to repay the bonds. If the Authority does not realize sufficient proceeds, not all bonds will be repaid.

Condensed entity-wide financial information as of September 30, 2007 and September 30, 2006 and for the fiscal periods then ended:

	2007	2006
Statement of Net Assets		
Assets:		
Current assets	$ 100,367,501	$ 34,059,652
Noncurrent assets	83,613,563	58,903,114
Total assets	$ 183,981,064	$ 92,962,766
Liabilities:		
Current liabilities	$ 15,963,269	$ 11,977,175
Noncurrent liabilities	1,003,562,888	492,237,160
Total liabilities	$ 1,019,526,157	$ 504,214,335
Net assets:		
Unrestricted	$ (835,545,093)	$ (411,251,569)
Total net assets (deficit)	$ (835,545,093)	$ (411,251,569)
Statement of Activities		
Revenues:		
Investment income	$ 4,080,822	$ 1,568,771
Miscellaneous income	162,020	76,010
Tobacco revenues	27,325,782	
Total revenues	$ 31,568,624	$ 1,644,781
Expenses:		
General government	$ 243,590	$ 276,243
Bond interest	40,618,164	13,620,107
Total expenses	$ 40,861,754	$ 13,896,350
Excess of revenues over (under) expenses	$ (9,293,130)	$ (12,251,569)
Discount on bonds issued	$ (394)	$
Transfers from other funds	33,293,314	1,000,000
Transfers to other funds	(448,293,314)	(400,000,000)
Total other financing sources (uses)	$ (415,000,394)	$ (399,000,000)
Excess of revenues and other sources over (under) expenses and other uses	$ (424,293,524)	$ (411,251,569)
Net assets - Beginning of period	(411,251,569)	0
Net assets - End of period	$ (835,545,093)	$ (411,251,569)

Total assets increased by $91.0 million as a result of the increase in investments, tobacco receivable recognition, and deferred bond issuance costs. Investments are held in the capitalized interest account which will be used to meet future debt service requirements. A portion of the bond proceeds from the 2007 bond issuance resulted in an increase of $60.8 million in investments. The recognition of the tobacco receivable and revenue earned in 2007 resulted in an increase to assets of $27.3 million. Under the sale agreement, the Authority was scheduled to receive its first payment in April 2008. Deferred bond issuance costs increased by $3.1 million as a result of the 2007 bond issuance.

Total liabilities increased by $515.3 million as a result of an increase in bonds payable from the 2007 bond issuance, accrual interest payable, and accretion in capital appreciation bonded debt. In fiscal year 2006-07, the Authority issued $523.0 million of bonds.

The **statement of activities** presents information showing how the Authority's net assets (deficit) changed during the fiscal year. Revenues increased by $29.9 million mainly due to the recognition of the tobacco receivable and revenue earned in 2007, which will be received in April 2008 under the terms of the MSA and the purchase and sale agreement between the Authority and the State of Michigan.

Expenses increased by $27.0 million as result of bond interest expense increase for the 2007 and 2006 bond issuances.

Transfers from other funds in fiscal year 2006-07 represents the transfer of funds from the special revenue fund to the debt service fund that was used to fund the $33.3 million debt service payments. In addition, transfers to other funds included $415.0 million of bond proceeds to the State School Aid Fund and General Fund in fiscal year 2006-07.

Contacting the Michigan Tobacco Settlement Finance Authority

The financial report is designed to present users with a general overview of the Authority's finances and to demonstrate the Authority's accountability for the funds generated. If you have questions about the report or need additional information, please visit the Department of Treasury Web site at <http://www.michigan.gov/treasury> and go to the section titled "Bond (Loan) Finance & Investments." The contact information for the Authority is:

Michigan Tobacco Settlement Finance Authority
Richard H. Austin Building, 1st Floor
430 W. Allegan
Lansing, MI 48922
Telephone: (517) 335-0994

FINANCIAL STATEMENTS

MICHIGAN TOBACCO SETTLEMENT FINANCE AUTHORITY
Statement of Net Assets and Governmental Fund Balance Sheet
As of September 30, 2007

	Governmental Fund Balance Sheet				
	Special Revenue Fund	Debt Service Fund	Total	Adjustments (Note 7)	Statement of Net Assets
ASSETS					
Current assets:					
Equity in common cash (Note 3)	$ 7,583	$	$ 7,583	$	$ 7,583
Investments (Note 3)	70,943,964		70,943,964		70,943,964
Due from component unit	35		35		35
Accrued interest receivable	1,963,949		1,963,949		1,963,949
Deferred bond issuance costs			0	126,188	126,188
Receivable from tobacco settlement	27,325,782		27,325,782		27,325,782
Total current assets	$100,241,313	$ 0	$100,241,313	$ 126,188	$ 100,367,501
Noncurrent assets:					
Investments (Note 3)	$ 75,899,365	$	$ 75,899,365	$	$ 75,899,365
Deferred bond issuance costs (Note 4)			0	7,714,198	7,714,198
Total noncurrent assets	$ 75,899,365	$ 0	$ 75,899,365	$ 7,714,198	$ 83,613,563
Total assets	$176,140,678	$ 0	$176,140,678	$ 7,840,386	$ 183,981,064
LIABILITIES					
Current liabilities:					
Interest payable	$	$	$ 0	$ 13,916,661	$ 13,916,661
Cost of issuance payable			0	293,101	293,101
Accounts payable and other liabilities	3,507		3,507		3,507
Bonds payable (Note 5)			0	1,750,000	1,750,000
Deferred revenue (Note 2)	27,325,782		27,325,782	(27,325,782)	
Total current liabilities	$ 27,329,289	$ 0	$ 27,329,289	$ (11,366,020)	$ 15,963,269
Noncurrent liabilities:					
Bonds payable (Note 5)			0	1,003,535,960	1,003,535,960
Compensated absences payable			0	26,928	26,928
Total liabilities	$ 27,329,289	$ 0	$ 27,329,289	$ 992,196,868	$1,019,526,157
FUND BALANCE/NET ASSETS					
Fund balance:					
Unreserved	148,811,389		148,811,389	$ (984,356,482)	
Total liabilities and fund balance	$176,140,678	$ 0	$176,140,678		
Net assets:					
Unrestricted (deficit) (Note 6)					$ (835,545,093)
Total net assets					$ (835,545,093)

The accompanying notes are an integral part of the financial statements.

MICHIGAN TOBACCO SETTLEMENT FINANCE AUTHORITY

Statement of Activities and Governmental Fund Statement of Revenues, Expenditures, and Changes in Fund Balance

For the Period October 1, 2006 through September 30, 2007

	Governmental Fund Statement of Revenues, Expenditures, and Changes in Fund Balance				
	Special Revenue Fund	Debt Service Fund	Total	Adjustments (Note 7)	Statement of Activities
REVENUES					
Investment income	$ 4,080,822	$	$ 4,080,822	$	$ 4,080,822
Miscellaneous income	162,020		162,020		162,020
Tobacco settlement revenues (Note 2)			0	27,325,782	27,325,782
Total revenues	$ 4,242,842	$ 0	$ 4,242,842	$ 27,325,782	$ 31,568,624
EXPENDITURES/EXPENSES					
General government	$ 3,144,670	$	$ 3,144,670	$ (2,901,080)	$ 243,590
Debt service:					
Bond interest and appreciation (Note 5)		33,293,314	33,293,314	7,324,850	40,618,164
Total expenditures/expenses	$ 3,144,670	$ 33,293,314	$ 36,437,984	$ 4,423,770	$ 40,861,754
Excess of revenues over (under) expenditures/expenses	$ 1,098,172	$ (33,293,314)	$ (32,195,142)	$ 22,902,012	$ (9,293,130)
OTHER FINANCING SOURCES (USES)					
Proceeds from bonds issued (Note 5)	$ 522,991,697	$	$ 522,991,697	$ (522,991,697)	$
Discount on bonds issued	(15,213,230)		(15,213,230)	15,212,836	(394)
Transfers from other funds (Note 8)		33,293,314	33,293,314		33,293,314
Transfers to other funds (Note 8)	(448,293,314)		(448,293,314)		(448,293,314)
Total other financing sources (uses)	$ 59,485,153	$ 33,293,314	$ 92,778,467	$ (507,778,861)	$ (415,000,394)
Excess of revenues and other sources over (under) expenditures/expenses and other uses	$ 60,583,325	$	$ 60,583,325	$ (484,876,849)	$ (424,293,524)
Fund balance/Net assets - Beginning of fiscal year	88,228,064		88,228,064	(499,479,633)	(411,251,569)
Fund balance/Net assets - End of fiscal year	$ 148,811,389	$ 0	$ 148,811,389	$ (984,356,482)	$ (835,545,093)

The accompanying notes are an integral part of the financial statements.

Note 1 Significant Accounting Policies

a. Organization

The Michigan Tobacco Settlement Finance Authority was authorized by the provisions of Act 226, P.A. 2005, which was amended by Act 18, P.A. 2007. The Authority's purpose is to issue bonds secured by a pledge of a percentage of the State of Michigan's tobacco settlement proceeds. The bond proceeds were used to finance projects under the 21st Century Jobs Trust Fund and make deposits to the State School Aid Fund and the General Fund. The purpose of the Act is to provide for the sale by the State and the purchase by the Authority of all or a portion of tobacco settlement payments per the master settlement agreement (MSA) and to authorize the issuance of bonds.

b. Reporting Entity

The accompanying financial statements report the financial position and changes in financial position of the Authority, a blended component unit of the State of Michigan, as of September 30, 2007 and for the fiscal year then ended. Accordingly, they do not purport to, and do not, present fairly the financial position and the changes in financial position of the State of Michigan or its component units in conformity with accounting principles generally accepted in the United States of America. The financial statements of the Authority are included in the *State of Michigan Comprehensive Annual Financial Report*. The Authority is administered by a board that consists of the State Treasurer, the director of the Department of Labor and Economic Growth, and 5 members who are appointed by the Governor with consent from the Legislature.

c. Basis of Accounting, Measurement Focus, and Financial Statement Presentation

Governmental fund financial statements are reported using the modified accrual basis of accounting. Revenues are recognized as soon as they are both measurable and available. Revenues are considered to be available when they are collectible within the current period or soon enough thereafter to pay liabilities of the current period. Debt service expenditures are recorded only when payment is due.

Entity-wide statements of net assets and statements of activities are reported using the economic resources measurement focus and the accrual basis of accounting. Revenues are recorded when earned and expenses are recorded when a liability is incurred, regardless of the timing of related cash flows.

The adjustment column on the financial statements represents transactions necessary to reconcile between the fund financial statements to the entity-wide financial statements.

Note 2 MSA and Purchase Agreement

In November 1998, an MSA was entered into by 46 states, 6 other U.S. jurisdictions, and the 4 major tobacco companies. The MSA sets forth the schedule and calculations of payments to be made by the tobacco companies to the states. These payments are subject to various adjustments and offsets, some of which could be material.

In 2006, the Authority and the State entered into a purchase agreement in which the Authority has purchased the right, title, and interest in and to 13.34% of all tobacco settlement revenue that is received by the State under the terms of the MSA and that is payable to the State on or after April 1, 2008.

In 2007, an additional 10.77% of future tobacco settlement revenue was purchased by the Authority on amounts payable on or after May 15, 2009.

Future tobacco settlement collections are contingent upon future tobacco product sales and are subject to various adjustments as outlined in the MSA. Because of the uncertainty of the factors affecting tobacco product sales and the various adjustments, the Authority estimates the amount of tobacco settlement payment that will be received in April of each year based on tobacco product sales from the prior calendar year.

The State of Michigan is currently in litigation over the application and interpretation of the market share adjustment and diligent enforcement provisions of the MSA. At best, the State of Michigan will avoid any reduction of its tobacco payments. At worse, an entire year's payment can be eliminated through application of the market share adjustment. The net effect of these adjustments on future payments is not determined.

The Authority recognizes the revenue and a receivable for the tobacco settlement payment in the accounting period that it will become measurable and available. For the governmental fund statements (modified accrual), the estimated tobacco receivable reflects revenue earned from January 2007 through September 2007; however, the revenue is reported as deferred because it will not be available. The entity-wide statements (accrual) reflect the estimated tobacco receivable as earned revenue.

Note 3 Deposits and Investments

The Authority is authorized by State statutes to invest any money of the Authority, at the Authority's discretion, in any obligations it determines are proper. The Authority records investments at fair value based on quoted market prices, except for short-term money market funds and nonparticipating interest earning investment contracts.

The Authority's deposits and investments are subject to several types of risk, which are examined in more detail below:

a. Deposits

Custodial credit risk

Custodial credit risk for deposits is the risk that, in the event of a depository financial institution's failure, the Authority's deposits may not be returned to it. The Authority had $7,583 of bank deposits in the State Treasurer's common cash fund at September 30, 2007. The State Treasurer evaluates each financial institution it deposits common cash funds with and assesses the level of risk of each institution. Only those institutions with an acceptable estimated risk level are used as depositories. To lessen credit risk, 0.2% of the total common cash fund is covered by federal depository insurance and 99.6% is collateralized with securities held in the State's name by the State's agent. The remaining 0.2% of the total common cash fund is uninsured and uncollateralized and exposed to custodial credit risk.

b. Investments

(1) Custodial credit risk

Custodial credit risk for investments is the risk that, in the event of a failure of the counterparty to a transaction, the Authority will not be able to recover the value of its investment securities that are in the possession of a counterparty. All financial institutions holding the Authority's investment must be a member of the Federal Reserve Bank, must be a member of the Federal Deposit Insurance Corporation, must have combined surplus and undivided profits of not less than $25 million, and must provide confirmation that they hold the securities, free and clear of any lien. At September 30, 2007, the following investment securities were held by the counterparty's trust department in the name of the Authority:

Type of Investment	Carrying Value
Government money market funds	$ 2,973,447
Guaranteed investment contracts	$ 37,801,532
U.S. government agencies - sponsored	$ 72,742,464
Commercial paper	$ 33,325,886

(2) Interest rate risk

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. For investments held in trust, investment maturities are structured to meet cash requirements as outlined in the bond indentures and other financing documents.

At September 30, 2007, the average maturities of investments were as follows:

Type of Investment	Fair Value	Less Than 1 Year	1 to 5 Years	6 to 10 Years	More Than 10 Years
Government money market funds	$ 2,973,447	$ 2,973,447	$	$	$
Guaranteed investment contracts	37,801,532				37,801,532
U.S. government agencies - sponsored	72,742,464	34,644,631	38,097,833		
Commercial paper	33,325,886	33,325,886			
Total investments	$ 146,843,329	$70,943,964	$38,097,833	$ 0	$37,801,532

(3) Credit risk

Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. The Authority's bond indenture restricts the Authority to investments rated A-1 or higher by Standard & Poor's, P-1 by Moody's Investors Service, and F1 by Fitch Ratings.

At September 30, 2007, the credit quality ratings of debt securities were as follows:

Type of Investment	Fair Value	Standard & Poor's Credit Quality Rating
Government money market funds	$ 2,973,447	AAAm
Guaranteed investment contracts	$ 37,801,532	A+
U.S. government agencies - sponsored (short-term)	$ 34,644,631	A-1+
U.S. government agencies - sponsored (long-term)	$ 38,097,833	AAA
Commercial paper	$ 33,325,886	A-1+

(4) Concentration of credit risk

Concentration of credit risk is the risk of loss attributed to the magnitude of the Authority's investments with a single issuer. The trust indenture limits investments in any single issuer or corporate entity to 20% of the aggregate principal amount of all eligible investments held. These limitations do not apply to U.S. treasuries, government agencies, or instrumentalities.

At September 30, 2007, the Authority had the following investments that represent 5% or more of total investments:

Issuer	Fair Value
Federal Home Loan Mortgage Corporation	$ 47,567,746
Guaranteed investment contracts - DEPFA Bank plc	$ 37,801,532
Citigroup	$ 33,325,886
Federal National Mortgage Association	$ 12,853,177
Federal Home Loan Banks	$ 12,321,541

Note 4 Deferred Bond Issuance Costs

Deferred bond issuance costs are the costs associated with the issuance of the bonds that will be amortized over the life of the bonds. The Authority has elected to use the interest method of amortization.

Note 5 Bonds Payable

Bonds payable consisted of the following at September 30, 2007:

Series	Date of Issue	Original Issue	Average Interest Rate Percentage	Ultimate Maturity Value
Tobacco settlement asset-backed bonds:				
Series 2006A - Serial	May 17, 2006	$ 363,115,000	7.31	$ 363,115,000
Series 2006B - Serial	May 17, 2006	72,620,000	Variable	72,620,000
Series 2006C - Capital appreciation	May 17, 2006	54,765,589	8.50	1,534,910,000
Series 2007A - Serial	August 17, 2007	480,125,000	5.125 to 6.00	480,125,000
Series 2007B - Capital appreciation	August 17, 2007	35,649,948	7.25	865,290,000
Series 2007C - Capital appreciation	August 17, 2007	7,216,749	7.50	195,100,000
Subtotal		$1,013,492,286		$3,511,160,000
Unamortized accretion interest on capital appreciation bonds				(2,490,639,417)
Discount on bonds payable				(15,234,623)
Total bonds payable outstanding				$ 1,005,285,960

The Authority issued tax-exempt tobacco settlement asset-backed bonds, Series 2007, dated August 17, 2007. The bonds consist of three series: (1) serial current interest bonds, (2) first subordinate capital appreciation bonds, and (3) second subordinate capital appreciation bonds. The bonds are special revenue obligations of the Authority secured solely by and payable solely from the tobacco settlement revenue pledged under the bond indenture. The bonds do not constitute an obligation of the State and are not backed by the credit revenues or taxing power of the State. Total bonds payable is net of discounts and includes the current value of accretion of capital appreciation bonds.

Interest on the Series 2006B bonds for each periodic interest accrual period beginning on or after December 1, 2006 will accrue at the rate of 2.15% per annum above the London interbank offered rate (LIBOR). During the period December 2006 through December 2007, the Series 2006B bonds will bear interest semiannually at the rates of 7.50% and 7.53%.

The annual requirements to service debt outstanding as of September 30, 2007, including both principal and interest, are as follows:

Fiscal Year	Principal	Interest	Total
2008	$ 1,750,000	$ 54,061,140	$ 55,811,140
2009	3,745,000	60,125,669	63,870,669
2010	7,100,000	59,917,338	67,017,338
2011	8,320,000	59,496,969	67,816,969
2012	9,580,000	59,021,474	68,601,474
2013 - 2017	70,615,000	284,261,005	354,876,005
2018 - 2022	106,300,000	256,561,341	362,861,341
2023 - 2027	129,100,000	217,793,849	346,893,849
2028 - 2032	190,440,000	163,874,476	354,314,476
2033 - 2037	148,370,000	94,700,231	243,070,231
2038 - 2042	105,440,000	60,285,000	165,725,000
2043 - 2047	1,670,010,000	24,906,000	1,694,916,000
2048 - 2052	1,060,390,000		1,060,390,000
Total	$ 3,511,160,000	$ 1,395,004,492	$ 4,906,164,492
Unamortized discount	(15,234,623)		(15,234,623)
Unpaid accretion for capital appreciation bonds	(2,490,639,417)		(2,490,639,417)
Total	$ 1,005,285,960	$ 1,395,004,492	$ 2,400,290,452

Changes in bonds for the period ended September 30, 2007 are summarized as follows:

	Beginning Balance	Additions	Reductions	Ending Balance	Amounts Due Within One Year	Amounts Due Thereafter
Ultimate maturity value	$ 1,970,645,000	$ 1,540,515,000	$	$ 3,511,160,000		
Unamortized discount	(21,787)	(15,213,230)	394	(15,234,623)		
Unamortized accretion of capital appreciation bonds	(1,478,413,541)	(1,017,523,303)	5,297,427	(2,490,639,417)		
Total bonds payable	$ 492,209,672	$ 507,778,467	$5,297,821	$ 1,005,285,960	$1,750,000	$1,003,535,960

Note 6 Deficit Net Asset Balance

The Authority is reporting a net asset deficit balance of $835,545,093 at September 30, 2007. The payments to be received under the MSA represent a share of anticipated future sales of tobacco products. Although the Authority expects to receive certain amounts under the MSA, the collections are not assured.

Under the accrual basis of accounting, such contingent amounts cannot be recognized as a receivable or revenue until the amount is measurable and available. Further, the Authority's outstanding bonds payable are recorded as a liability on the entity-wide financial statements.

Note 7 Reconciliation Between the Fund Level and the Entity-Wide Financial Statements

a. Balance Sheet to Statement of Net Assets

The following is an explanation of the adjustments between the governmental fund balance sheet and the statement of net assets, which reconciles fund balance to net assets:

Fund balance	$ 148,811,389
Adjustments:	
Deferred bond issuance costs are expended in governmental funds whereas they are capitalized and amortized over the life of the bonds	7,840,386
Accrued interest payable on bonds is not recorded on the modified accrual basis of accounting by governmental funds	(13,916,661)
Cost of issuance payable is not recorded by governmental funds	(293,101)
Bonds payable are not reported on the modified accrual basis of accounting until they are due and payable	(1,005,285,960)
Tobacco revenue receivable in April 2008 is not recognized as earned revenue because under the modified accrual basis of accounting the revenue is not available as of the end of the reporting period	27,325,782
Compensated absences payable is not recorded under the modified accrual basis of accounting	(26,928)
Net assets (deficit)	$ (835,545,093)

b. <u>Statement of Revenues, Expenditures, and Changes in Fund Balance to Statement of Activities</u>

The following is an explanation of the adjustments between the governmental fund statement of revenues, expenditures, and changes in fund balance and the statement of activities, which reconciles the net change in fund balance to the change in net assets:

Net change in fund balance	$ 60,583,325
Tobacco revenue receivable in April 2008 is not recognized as earned revenue because under the modified accrual basis of accounting the revenue is not available as of the end of the reporting period	27,325,782
The issuance of bonds provides current financial resources and bond issuance costs and discounts are uses of current financial resources:	
Proceeds from bonds issued	(522,991,697)
Discount on bonds issued	15,213,230
Amortization of discount on bonds issued as general government expense	(394)
Cost of issuance and underwriter's discount paid as **general government** expense	2,984,950
Amortization of deferred bond issuance costs as general government expense	(84,430)
Bond interest expense is not recorded by governmental funds but is reported under interest for purposes of net assets	(7,324,850)
Compensated absences expense is not recorded by governmental funds but is reported as an expense for purposes of net assets	560
Change in net assets	$(424,293,524)

Note 8 Transfers

The Authority sold $523.0 million of bonds and transferred $415.0 million into the State School Aid Fund and the General Fund in accordance with Act 18, P.A. 2007.

In addition, $33.3 million was transferred to the debt service fund for the December 2006 and June 2007 debt service payments.

INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL AND COMPLIANCE

STATE OF MICHIGAN
OFFICE OF THE AUDITOR GENERAL
201 N. WASHINGTON SQUARE
LANSING, MICHIGAN 48913
(517) 334-8050
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THOMAS H. MCTAVISH, C.P.A.
AUDITOR GENERAL

Independent Auditor's Report on Internal Control Over Financial Reporting and on Compliance and Other Matters

Mr. Robert J. Kleine, Chair
Michigan Tobacco Settlement Finance Authority Board
Richard H. Austin Building
Lansing, Michigan

Dear Mr. Kleine:

We have audited the financial statements of the Michigan Tobacco Settlement Finance Authority, a blended component unit of the State of Michigan, as of and for the fiscal year ended September 30, 2007, as identified in the table of contents, and have issued our report thereon dated December 21, 2007. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Michigan Tobacco Settlement Finance Authority's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements but not for the purpose of expressing an opinion on the effectiveness of the Authority's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Authority's internal control over financial reporting.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Michigan Tobacco Settlement Finance Authority's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and use of management, the Michigan Tobacco Settlement Finance Authority's Board of Directors, others within the Authority, and the Legislature and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record and its distribution is not limited.

Sincerely,

Thomas H. McTavish

Thomas H. McTavish, C.P.A.
Auditor General
December 21, 2007

GLOSSARY

control deficiency in internal control over financial reporting	The design or operation of a control that does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.
financial audit	An audit that is designed to provide reasonable assurance about whether the financial schedules and/or financial statements of an audited entity are presented fairly in all material respects in conformity with the disclosed basis of accounting.
GASB	Governmental Accounting Standards Board.
internal control	A process, effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance about the achievement of the entity's objectives with regard to the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations.
material misstatement	A misstatement in the financial schedules and/or financial statements that causes the schedules and/or statements to not present fairly the financial position or the changes in financial position or cash flows in conformity with the disclosed basis of accounting.
material weakness in internal control over financial reporting	A significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial schedules and/or financial statements will not be prevented or detected.
MSA	master settlement agreement.

significant deficiency in internal control over financial reporting	A control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial schedules and/or financial statements that is more than inconsequential will not be prevented or detected.
unqualified opinion	An auditor's opinion in which the auditor states that the financial schedules and/or financial statements presenting the basic financial information of the audited agency are fairly presented in conformity with the disclosed basis of accounting.

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STATE OF MICHIGAN

OFFICE of the AUDITOR GENERAL